

# Pengana Emerging Companies Fund



Australian Equities – Small Caps

## December 2007 Quarterly Review

The Pengana Emerging Companies Fund posted a net return of 6.1% over the December quarter, compared with the benchmark performance of negative 1.0%. For the 2007 year, the fund returned 34.9% outperforming the smallcap benchmark by 17.8%. The results are pleasing given that the fund does not invest in resources stocks, which rallied 46% in 2007. Excluding the resources sector, the fund outperformed the small industrial benchmark by 27.3% in 2007.

The fund is now closed to new investors in order to preserve its ability to perform given the liquidity constraints inherent in smallcap investing.

### Total return performance for periods ending 31 December 2007 <sup>1</sup>

	3 mths	6 mths	1 yr	2 yrs p/a	Since inception p/a*
<b>Pengana Emerging Companies Fund</b>	6.1%	4.7%	34.9%	44.8%	<b>38.0%</b>
<b>S&amp;P/ASX Small Ordinaries Acc Index</b>	-1.0%	-1.5%	17.1%	25.3%	<b>23.0%</b>
<b>Outperformance</b>	<b>7.1%</b>	<b>6.2%</b>	<b>17.8%</b>	<b>19.5%</b>	<b>15.1%</b>
<b>S&amp;P/ASX Small Industrials Acc Index**</b>	-3.8%	-6.8%	7.6%	16.9%	<b>17.0%</b>
<b>Outperformance</b>	<b>9.9%</b>	<b>11.5%</b>	<b>27.3%</b>	<b>27.9%</b>	<b>21.0%</b>

\* Since Nov 1, 2004

\*\* The fund does not invest in resource stocks

<sup>1</sup> Total return performance figures are derived from Manager's records and are shown after all fees, and assume reinvestment of income. Investments can go up and down. Past performance is not a reliable indicator of future performance.

## Market backdrop

The December quarter was highly volatile, with the All Ordinaries falling 2.4%. The recent disruptions in global credit markets were brought closer to home in December, when Centro Properties, a top 50 stock, lost almost 90% of its value in three days. This was due to its inability to refinance the debt on its portfolio of shopping centres, and reminded investors that the steadily rising market in the past four years still involved a high level of risk. Smallcaps were similarly volatile, falling 1.0% during the quarter, with the resources sector actually rising by 5.2% and the industrials falling 3.8%.

## Key stock moves during the quarter

Key successes for the fund during the period included **BSA**, **Flight Centre**, **Incitec Pivot**, **Mac Services** and **Mineral Resources**. Key detractors were **Bradken** and **Dexion**.

**BSA** rose 45% following the acquisition of Hills Industries' antenna and installations operations, which left Hills a 51% owner of BSA. **Flight Centre** rallied 49% following two profit upgrades and the acquisition of US travel chain Liberty Travel. **Incitec Pivot** rose 40% due primarily to ongoing strength in fertilizer prices as global demand rises (esp. India and China) and capacity remains constrained. **Mac Services** and **Mineral Resources** rallied 51% and 59%, respectively. Both stocks are exposed to



the resources cycle and have added to their already high quality earnings streams through contract wins in recent months.

**Bradken** was, disappointing, falling 25% after a profit warning centered around a problem contract in its UK operations. We sold our position on the day, and since then the stock has fallen a further 35%. **Dexion** continues to slide amid concerns that contract delays will impact shorter term results. The upcoming profit announcement should provide clarity and show the stock to be oversold.

## Portfolio activity

During the period, we pared back our exposure to some stocks which had risen strongly such as **Ausenco**, **Cabcharge**, **Mineral Resources**, **The Reject Shop**, and **Reverse Corp**. We also cleared our active holding in **Blue Freeway** following a deterioration in the earnings clarity, and as mentioned above, sold our **Bradken** following the profit warning.

New additions include WA based construction group **Brierty** which was floated in December, engineering consulting outfit **Cardno**, and the internet travel company **Webjet**. We also increased our weighting in existing holdings such as **CSG Group**, **Mac Services**, and **Toxfree Solutions**.

Top 5 positions in the fund
Australian Wealth Management
CSG Group
Fleetwood
Mac Services
Mineral Resources

## Outlook

The recent volatility in global markets has shaken confidence perhaps more than other retracements in the prior four year bull market. Especially concerning is that the largest corporate disaster in Australia last year occurred in what is usually considered the lowest risk sector of the market; property. Further rounds of bad news are likely as the sub-prime issues unfold, and rising fears of a US recession are unlikely to disappear shortly.

The implications for the Australian market are twofold. Short term global volatility will continue to impact on our market, driven primarily by fear and capital flows. Beyond that, however, a sustained downturn in the domestic market would imply meaningful downside to the earnings of Australian domestic stocks, which we do not currently see as a major risk given the strength of the domestic economy, and strong demand for resources from China. Recent research from UBS estimates that 6% of China's workforce is employed in sectors which export products to the US, which should insulate the Chinese economy from a US recession.

In the smallcap sector, one further implication is a decrease in investor appetite for risk. Some of the most poorly performing stocks in 2007 were ones where aggressive acquisition strategies came under pressure (e.g. Downer, Staging Connections, Candle), sometimes exacerbated by excessive debt levels (e.g. Commander, Traffic Technologies, Funtastic). Another obvious area of disappointment lay in financial stocks with opaque earnings streams (e.g. Allco, MFS, Blue Chip Financial). Highly valued stocks which rely on future commercialization of technology (e.g. Silix) have also been hard hit due to their lack of firm valuation support.

We do not expect investors to quickly re-embrace riskier stocks in the short term, and indeed can see further scope for disappointment, especially in instances where acquisition has been the primary driver



## Pengana Emerging Companies Fund

of earnings growth. As access to capital slows, the focus shifts to operating performance rather than exciting acquisitions announcements, which is often harder work than anticipated.

Our fund is conservatively managed in that we do not invest in unprofitable companies, or those whose cash flows are not easy to understand. We also take a harsher view on companies which require acquisitions to grow. The recent closure of our fund also aids our ability to exit positions which fundamentally change.

We remain highly exposed to services companies in the mining, IT and financial services sectors. In each case, however, we have focused on stocks with visible medium term earnings streams, rather than lumpy short term earnings which can reverse quickly. In financial services for example, we prefer stocks which derive recurring revenues on assets under management/advice (e.g. financial planners, fund managers, platforms) over transactional stocks such as the merchant banks. In mining services we prefer stocks with longer term contracts based on production volume locked in over those which rely on shorter term construction style revenues which involve lumpy margins and can dry up quickly if there is a lull in projects.

In summary we believe volatility will continue, risk appetites will remain low, and therefore the riskier sectors in the market will continue to underperform. Despite overall market directions, the single most important driver of performance remains stock picking, which we believe requires constant company contact. To this end we had over 320 company visits in 2007, and plan to continue at that pace in order to identify the key investment opportunities.

## Company visits

Our central belief is that contact with management is the key to unlocking value within the smallcap sector, hence during the quarter we made face-to-face contact with 64 companies and unlisted competitors of listed stocks. The table below shows the listed companies with which we had direct contact during the period.

Ambition	E&A	Radio Rentals
Ansell	Essa	Ruralco
AP Eagers	Fiducian	Saferoads
APN Property	Fleetwood	Savcor
ASG Group	Flight Centre	Sedgman
Austin Engineering	Fortescue	seek.com.au
Automotive Holdings	Global Construction	Sky TV
Boom Logistics	GWA International	SMS Mgmt
Bradken	IGL Ltd	Style
Bravura	Incitec Pivot	Swick
Brierty	Logicamms	Talent 2
BT Investment	M2 Comms	Tassal
Cardno	Mineral Resources	Think Smart
Challenger Infrastructure	Monadelphus	Tower Australia
Clean Seas Tuna	Mortgage Choice	Toxfree
CommQuest	NIB	Tutt Bryant
ComOps	Norfolk	Vision Group
Coote Group	NRW Holdings	Webster
CSG Group	Oakton	Wilson HTM
Dexion	Oakton	Wridgways
DKN Group	Platinum	
DWS Advanced	Pulse Health	

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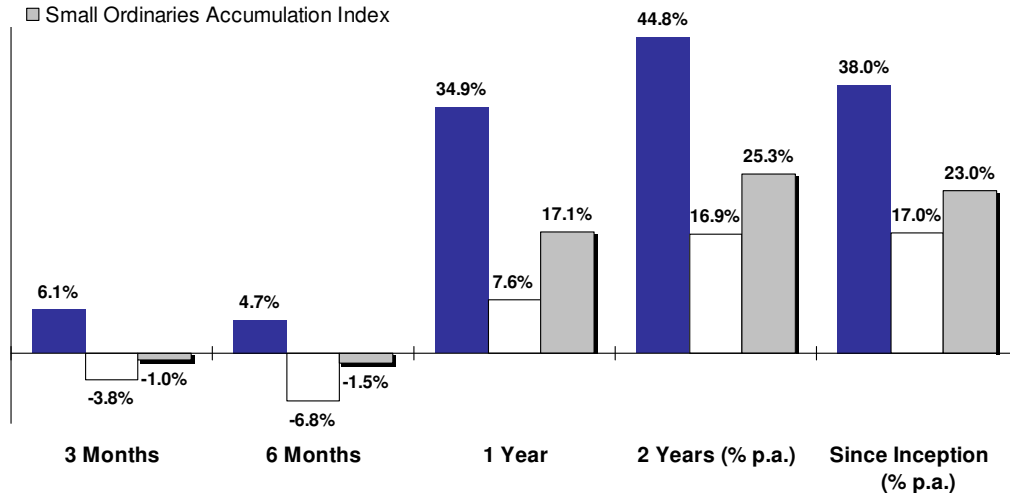
ABN 301 0380 0568 AFSL 226 566

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## Performance to 31 December 2007 (After Management Fees & Performance Fees)

- Pengana Emerging Companies Fund \*
- Small Industrial Accumulation Index
- ▒ Small Ordinaries Accumulation Index



\* Since Nov 1, 2004.

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For more information on the fund visit our web site on <http://www.pengana.com.au/>

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